subject to the uneconomic Part 69 access charge structure.[103] This means that the conditions for Phases I-B and I-C in the NYNEX plan will be met simultaneously as soon as a LEC has a state-approved agreement in place.

Once a state-approved interconnection agreement is in place, the LEC will not be able to exercise market power in the pricing of access services, because alternative providers will be able to purchase unbundled elements from the LEC at cost and undercut unreasonable rates for access services, local telephone lines, or any other services that the LEC offers through its local network. Conversely, the LEC will need the pricing flexibilities described above, since the new entrant will not be restricted by Part 69 access structure rules, and will not have the burden of uneconomic jurisdictional cost allocations. Regardless of the LEC's market share, all of its customer base will be subject to challenge if its end user rates are not economic. New entrants will be able to attract customers anywhere in the LEC's study area, since the carrier can provide local telephone service through the purchase of the LEC's unbundled network elements without having a physical presence in the customer's serving area..

Phase I should include the types of pricing flexibility described in Phase 1, as well as most of the pricing flexibility detailed in Phase 2, in the Notice.[104] This would include

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[103] Indeed, competitors using unbundled elements will be able to purchase these elements at rates that are below LECs' actual costs. Although the pricing provisions of the Commission's interconnection order have been stayed, "most of the states are using a forward-looking methodology, similar if not identical to the FCC's choice of TELRIC." A. Kovacs and K. Burns, "The Status of Agreements Between the Major LECs and CLECs," Janney Montgomery Scott Industry Update (Dec. 23, 1996).

[104] Notice, ¶¶ 180-200, 211-217.

geographic deaveraging of all access rates including the SLC,[105] volume and term discounts for all access services, contract tariffs and individual responses to requests for proposals ("RFPs"), deregulation of new services, consolidation of price cap service categories and baskets, and differential pricing for different classes of customers.

As part of Phase 1 relief, the Commission should remove price regulation on new services, new service options and alternative pricing plans. New services are discretionary by definition.[106] If the service is overpriced or otherwise flawed, the market will reject the service. To the extent the market accepts the service, it means that customers believe they are better off buying a service at the tariffed rate than not buying the service. For alternative pricing plans, potential buyers will continue to have the original tariffed service as an option. They will only buy the new service to the extent they are better off.

Once a new service is being offered, the Commission should not impose price regulation, regardless of the level of competition. As Professor Alfred Kahn has previously explained:

> The logic of extending the deregulation of all effectively competitive services to all new services -- whether or not subject to effective competition -- is straightforward. To the extent that services are truly new, the conception of monopoly power in their provision is of dubious meaning or significance. New services offer customers additional alternatives not available to them previously. In the broader sense,

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105 Deaveraging of the SLC should be subject to the existing $6.00 and $3.50 caps. To avoid arbitrage, the zones for deaveraging should be made consistent with any zones that are established by a state for deaveraging unbundled network elements. The existing zones for deaveraged Special Access and switched transport services, which are based on density levels at each end office, are unlikely to match the geographic areas for unbundling. In the future, however, zones for deaveraged access charges will probably have to be aligned with the zones that are used to deaverage unbundled network elements.

106 ***See*** Affidavit of Alfred E. Kahn at ¶ 32, attached to Reply Comments of Bell Atlantic ***Price Cap Performance Review for Local Exchange Carriers***, CC Docket No. 94-1 (filed June 29, 1994) ("Kahn Affidavit").

> therefore, their introduction is fundamentally a competitive rather than a monopolistic phenomenon, . . .
>
> There is no reason to deny an innovator the rewards of being first -- denial would inhibit innovation -- and it should not matter whether the innovator is a LEC or a new entrant.[107]

Removing these services from price regulation means that tariffs for these services will be filed on one day's notice with no cost support and that further price changes will not be subject to the price cap rules. While one-day tariffs without cost support should be allowed for all services, this result is especially appropriate in the case of new services. Tariff reviews of Bell Atlantic services have delayed introduction of new services as much as 83 days[108] and 45 days on average (in addition to the typical 45 day notice period). Ironically, customers suffer the brunt of the harm from these delays.[109]

Moreover, delays often occur where no legitimate concerns are raised.[110] To the extent some services never are brought to market because of these regulatory hurdles, the harm to

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107 Kahn Affidavit at ¶¶ 30-31.

108 ***See, e.g.***, Bell Atlantic Tariff FCC No. 1, Trans. Nos. 700, 740 & 751; *see also* NYNEX Telephone Companies Tariff FCC No. 1, Transmittal No. 1398, filed Nov. 7, 1995 (delayed an additional 75 days).

109 ***See, e.g.***, Letter from Kelsey W. Hill, Marriott Vice President to William F. Caton, Acting Secretary, filed in CC Docket No. 94-1 (Jan. 19, 1996) (Marriott reports "numerous" tariff filing delays "resulting in both delay in delivering new important services and lost savings benefits for Marriott").

110 For example, Bell Atlantic's Group Link Video was introduced to compete with established providers of the service including AT&T and Sprint. Bell Atlantic demonstrated that its proposed rates were at or below those of other competitors. Nevertheless, Bell Atlantic's tariff was delayed two months beyond the forty-five day delay inherent in the notice rules because of a meritless complaint by a potential competitor that the proposed rates were too high. ***See Bell Atlantic Telephone Companies, Revisions to Tariff F.C.C. No. 1***, 10 FCC Rcd 10869 (Com. Car. Bur., 1995).

customers is even greater. Regardless, the Commission retains jurisdiction under the complaint process to deal with any concerns raised by potential competitors or customers.[111] The difference is that the service will be available to customers in the meantime.[112]

Of course, tariff reform will not prevent regulatory delay if the Commission continues its dual application requirement. In the Third Report and Order, the Commission eliminated the Part 69 waiver requirement. Unfortunately, it replaced it with a vague public interest test. Like the Part 69 waiver application, this test serves as a preliminary barrier before a new service tariff can even be filed. The Commission would best serve customers if it allowed the market to evaluate the public interest in new services and eliminated any pre-filing qualification requirement.

The Commission's recent denial of a waiver of Bell Atlantic's switched FMS service is an example of the regulatory harm imposed by a pre-filing qualification requirement.[113] The petition to offer the service was under review for 33 months.[114] During that period, the equivalent special access service, which did not require a waiver, was in effect, offering customers a new alternative and Bell Atlantic a new way to attract and retain customers.

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111 47 U.S.C. § 208(a) ("Any person . . . complaining of anything done or omitted to be done by any common carrier subject to this Act . . . may apply to said Commission by petition.")

112 Moving disputes to the complaint process will also have the beneficial effect of reducing the number of frivolous filings by reducing the incentive of those parties that "game" the regulatory process by filing objections that have no purpose other than to delay the introduction of a competitive service.

113 ***Waiver of the Commission's Access Charge Rules, Bell Atlantic Petition for Waiver Part 69.112 (b) and (c) of the Commission's Rules to Offer Facilities Management Service***, DA 96-2185, Order (rel. Dec. 26, 1996) ("FMS Order").

114 ***Bell Atlantic Petition for Waiver Part 69.112 (b) and (c) of the Commission's Rules to Offer Facilities Management Service*** (filed April 4, 1994).

Ultimately, the service was not rejected because of any concern relevant to the service, but because the Commission found that Bell Atlantic did not demonstrate any unique reason why the current rate structure should be waived.[115]

Alternative pricing plans should be deregulated as well. The regulatory flexibility in Phase 1 is really a series of pricing options that should be allowed immediately as deregulated new services. So long as an original baseline service remains price controlled -- either through regulation or competition -- alternative pricing plans should not be price regulated. Customers will only buy from the alternative pricing plan if the plan makes them better off than had they continued with the original service. No matter what the alternative pricing plan terms, no customer is worse off than they would have been if the option had not been available.[116]

For example, term and volume discounts are efficient pricing mechanisms that are universally employed in other industries.[117] It is perverse logic to argue that no customers should be able to take advantage of these discounts unless all customers can do so. If some receive the discounts they are better off, and the customers who do not qualify or do not choose to participate are no worse off. Moreover, under the Act, all LEC services are available for resale, which provides an opportunity for competitors to aggregate customers so that they can qualify for the discounted price. This potential price arbitrage eliminates any remaining concern that

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115 FMS Order, ¶ 6.

116 Affidavit of Richard J. Gilbert and Robert G. Harris at ¶ 20, attached to Comments of Bell Atlantic, ***Price Cap Performance Review***, CC Docket No. 94-1 (filed December 11, 1995) ("Gilbert and Harris Affidavit").

117 ***See*** Gilbert and Harris Affidavit, ¶ 23; Affidavit of William E. Taylor at ¶ 25, attached to Reply of Bell Atlantic, ***Tariff FCC No. 1***, Trans. No. 741 (filed March 6, 1995) ("Taylor Dover Affidavit").

term and volume discounts can cause unreasonable price discrimination.[118] LEC competitors who complain about term and volume discounts only wish to perpetuate regulatory impediments to more customer responsive pricing.

Similarly, LECs should be allowed to engage in contract pricing -- tariff packages of multiple services that are designed to meet specific end-user consumers' needs. Absent such authority, these needs are either met by other companies -- who frequently are not the most efficient provider -- or not met at all.[119] For example, in February 1996, NYNEX filed a tariff to provide NYNEX Enterprise SONET Access Service to Fidelity Management and Research Company in the Boston area.[120] This tariff proposed rates, terms and conditions that were developed to respond to a Request for Proposal (RFP) issues by Fidelity. Even though the tariff proposed was narrowly crafted to apply only to the SONET service, and only to customers in similar circumstances where there was a bona fide RFP by another qualified provider, the Commission could not see a clear avenue for approval of such a tariff. The Fidelity tariff was subsequently withdrawn, and the benefits of competitive pricing and terms contained in the proposal were not available to the customer.

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118 *See* Taylor Dover Affidavit at ¶ 28.

119 As the Commission recognized with respect to AT&T, it retains statutory authority to ensure that rates are just, reasonable and non-discriminatory and, in the context of a complaint or enforcement proceeding, can require the filing of the underlying contract to ensure that contract tariffs reflect the underlying agreements and do not violate core regulatory concerns. ***Motion of AT&T Corp. to be Reclassified as a Non-Dominant Carrier***, 11 FCC Rcd 3271, 3342 (1995) ("AT&T Non-Dominance Order").

120 NYNEX Transmittal No. 405, Feb. 7, 1996.

Allowing LECs to respond to their customers' needs is distinctly pro-consumer and pro-competitive.[121] If the LEC cannot offer a package that meets customers' needs and that is competitive with packages offered by other providers, it will fail in the marketplace. Moreover, as with other optional services, no customer is harmed from the addition of new service packages.[122] For the same reasons, the Commission should allow the LECs to file competitive response tariffs as part of Phase I relief.[123]

Rate deaveraging is another form of pricing flexibility that better allows LECs to compete and meet customers' needs. LECs will compete with carriers using the LECs' own unbundled elements that may be priced by zone. To the extent competitors benefit from lower prices for network elements in certain zones, it is only reasonable that the LECs have the opportunity to deaverage their own services. Rather than attempt to link such zone pricing to a strict cost showing, the Commission should rely on market forces.

Similarly, there is no reason to require a competitive showing prior to allowing differential pricing for different classes of end-users, as included in the Commission's proposed Phase 2 relief.[124] Indeed, such relief can be seen simply as another method of offering deaveraged rates. There is no reason to condition such relief on any additional showing.

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[121] ***See, e.g.,*** J. Haring and H.M. Shooshan, "Universal Competition in the Supply of Telecommunications Service: Eight Customer Perspectives," at 37 (director of Telecommunications Planning & System Design for Marriott International notes that while Marriott would like to find vendors to provide telecommunications services at competitive prices "[t]he current tariff structure impacts [Marriott's] ability to meet that goal.").

[122] ***See*** Gilbert and Harris Affidavit at ¶¶ 20, 23.

[123] ***See*** Notice, ¶ 196.

[124] Notice, ¶ 212.

B. Phase 2 Relief Should Eliminate Price Regulation and Part 69 Rate Structure Requirements Whenever A Competitive Alternative is Available. (¶¶ 15, 201-217)

To the extent competition acts as a check on price, there is no basis for continued Part 69 rate structure controls or any price regulation. The true Phase 2 of the Commission's regulatory reform of access must be the elimination of price controls. The Commission has recognized that price cap regulation only needs to be left in place until competition is present.[125] To honor that principle, the Commission should establish a mechanism that quickly removes price regulation wherever a competitive alternative is available. That determination should be made based on a flexible showing by the LEC that covers the service(s) and area(s) impacted. It is likely that the initial filings will reflect the already vigorous competition in high-margin services and in high-density areas.

When customers have one or more potential alternative service providers, these competitors provide a market-based check on prices.[126] So long as the potential provider has the capability and willingness to offer a competitive service, super normal pricing is checked by the market. As a practical matter, that is the only necessary test to eliminate continued price regulation. This concept, sometimes called "addressability," is similar to the "uncommitted entrant" concept in the 1992 Department of Justice/Federal Trade Commission Horizontal Merger Guidelines.[127] The Guidelines treat the uncommitted entrant as if it were an actual

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125 ***See*** Price Cap Review Order at 8965-8966.

126 ***See*** Kahn Affidavit at 13-14; ***see also*** Gilbert and Harris Affidavit at ¶¶ 26-28, Crandall Affidavit at ¶ 24.

127 ***See*** Gilbert and Harris Affidavit at ¶ 33.

supplier because it imposes a competitive check on prices.[128] If the incumbent's price becomes too high, the uncommitted entrant will enter the market at a price level lower than the incumbent.

In the post-Act world, all markets should be viewed as addressable as soon as the competitive checklist has been met. Whether through resale or through unbundled loops, a competitor can reach any customer immediately. While the competitor can also use the interconnection rules to connect its own facilities, the below-cost pricing of unbundled elements provide an incentive to compete using the LEC's existing facilities.

A LEC will need to demonstrate that one or more competitors are in place and offering services to a reasonable number of customers before removing all price restraints.[129] Once that happens, the price pressure from unbundled elements and other competitive alternatives will provide a sufficient check so as to allow all access services to be free from regulation. If the competitive alternative arises for a specific service or in a smaller geographic area, the individual LEC must have the option of making the appropriate showing for whichever service and whatever area there is competition.

The Commission should avoid relying on market share to measure the level of competition necessary to eliminate regulation. Market share is a backward looking measure that can fail to capture the presence of competitive alternatives.[130] Firms with high market share may

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[128] ***Id.***

[129] For example, this showing could include a list of competitors, areas served, services provided, identification of unbundled facilities, and identification of carriers that have been provided with NXX codes.

[130] Because data on non-regulated competitors is not readily available, measures of market share are likely to overstate even the historical market position of incumbent LECs.

lack sufficient market power to control prices.[131] This is especially true if, as it is for all LEC interstate services, there is unconstrained entry and exit for potential competitors. For the LECs, market share is even less meaningful given the mandated opening of their market through unbundled elements and resale. A new competitor can reach virtually the entire market overnight. In such a market, historical market share figures are irrelevant.

Reliance on market share is affirmatively harmful when used to force markets to remain price regulated well after competition is present.[132] LECs incur higher costs and are at a competitive disadvantage when operating under price regulation rather than under market conditions. Initial competitive losses will be for higher margin services and market segments. Thus, a small market share loss could have a substantial impact on profitability. If the Commission were to continue imposing unique obligations on the LECs until they suffer a significant loss of market share, the Commission would skew the market results with no benefit to consumers. Indeed, it would be unclear whether future market share losses were the result of natural competition or an implicit regulatory allocation of the market. This is in direct contradiction to the requirements of the Act.[133] The Commission should resist inevitable calls by LEC competitors to mandate a market share test that prolongs the competitors' regulatory advantage over the LECs at the expense of the public.

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131 Indeed, the Commission recognized that a market share test was not essential when it declared AT&T a non-dominant carrier. "It is well-established that market share, by itself, is not the sole determining factor of whether a firm possesses market power." AT&T Non-Dominance Order at 3307

132 Economic Aspects at 36.

133 ***See*** 47 U.S.C. § 160.

Finally, the Commission should not make implementation of competitively neutral universal service funding mechanisms a pre-condition to any phase of regulatory relief.[134] The LECs have no control over the timing or structure of universal service funding mechanisms that the Commission or the state regulatory commissions may adopt. It would be neither fair nor effective to "punish" the LECs for the Commission's or a state's failure to comply with the requirement of Section 254 of the Act that universal service funding be competitively neutral. If any party believes that the Commission or a state has not carried out this mandate, it can pursue its judicial remedies. Moreover, the current implicit funding mechanisms for universal service primarily disadvantage the LECs, because they must charge above-cost rates for certain services, such as toll calls and business services, to support below-cost rates for services such as residential exchange line and state Lifeline services. This gives competitors, who do not carry such universal service burdens, the ability to undercut LEC rates to high-margin customers. Therefore, universal service funding gives no advantage to the LECs, and reform of universal service should not stand in the way of pricing flexibility or removal of services from price regulation.

C. Services That Are Already Subject To Competition Should Be Removed From Price Regulation Immediately. (¶¶ 14, 30, 149-160)

Services in the interexchange basket, Special Access, direct-trunked transport in areas that have operational collocation, operator call completion services, and directory assistance are already subject to competition. Therefore, these services merit immediate deregulation.

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134 *See* Notice, ¶ 206.

The interexchange basket contains limited interexchange services that the LECs have provided since divestiture, such as corridor service, interstate intraLATA services, and interstate operator services surcharges. These LEC services represent a miniscule share of the total interexchange market, and the LECs have no ability to exercise market power with regard to rates for those services. Corridor service is limited to certain geographic areas,[135] and the LECs are handicapped in marketing services to these areas while the IXCs can offer nationwide and international calling. As Bell Atlantic demonstrated in its petition to be regulated as a nondominant carrier in the corridor, nine out of ten customers in the New Jersey/New York corridor do not use Bell Atlantic's services.[136] It makes no sense to regulate Bell Atlantic and NYNEX as dominant carriers in the corridor while giant IXCs like AT&T, MCI, and Sprint are unregulated.

Special Access and switched transport services are also subject to competition. Competitive LECs ("CLECs") provide alternative dedicated facilities transport in most cities, and the Commission's collocation policies have made it feasible for the CLECs to offer competitive Special Access and switched transport services from LEC central offices to both end user premises and IXC POPs.

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135 Indeed AT&T has argued that the corridor areas are even more competitive than the market in general. ***See AT&T Petition for Waiver of Section 64.1701 of the Commission's Rules***, CCB/CPD 96-26, AT&T Corp.'s Petition for Waiver and Request for Expedited Consideration (filed Oct. 23, 1996).

136 ***Petition to Regulate Bell Atlantic as a Nondominant Provider of Interstate InterLATA Corridor Service***, DA 95-1666, at 4-5, attached Declaration of Robin A. Lewis-Ivy, at ¶ 6 (filed July 7, 1995).

Surcharges associated with transferring operator assistance calls to IXCs should also be considered competitive. There are hundreds of providers of operator services, and some of the largest, such as AT&T and MCI, offer 800 dial-around services that bypass LEC operator call completion services. Many private payphones are presubscribed to non-LEC operator services providers, and many customers use prepaid phone cards that bypass LEC operator services. Thus, this market is highly competitive, and justifies immediate price deregulation.

Directory assistance should also be considered subject to effective competition. Computerized directory listings have been available for some time which allow competing carriers to offer directory listing services, and to allow IXCs to avoid referring directory assistance calls to the LECs. In fact, many large carriers have stopped purchasing directory assistance service from Bell Atlantic and NYNEX in several states. AT&T and MCI offer 1-900 service that allows customers to obtain telephone numbers for anyone in the United States. Individuals can access this information from their own personal computer or at their local library. In addition, nationwide directory listings are available free of charge on Internet sites. In short, directory assistance services are widely available from a variety of sources, and the LECs need the ability to compete for the IXCs' directory assistance business.

All of these services warrant immediate removal from price regulation, regardless of whether a LEC has presented evidence that it has implemented Section 251 through interconnection agreements or a statement of terms and conditions. These services were competitive before the Telecommunications Act of 1996 was passed, and they will remain competitive both before and after barriers to entry in other markets or services are removed.

VI. Changes in Regulatory Price Caps Should Be Linked to Productivity. (¶¶ 231-233, 294)

. As part of its order reforming access rates, the Commission should put in place the final price cap mechanism to be used prior to competition supplanting price regulation. The Commission has already recognized that the price cap productivity offset should be based on an industry-wide measure of productivity that reflects actual performance since price cap regulation.[137] Moreover, the Commission has expressed a preference for a study based on total factor productivity ("TFP")[138] -- the economically correct measure of achieved productivity.

Following the interim price cap review, the LEC industry submitted a simplified total factor productivity model that addressees the Commission's concern over implementation.[139] The simplified TFP approach uses only publicly available and verifiable data. Moreover, LECs have demonstrated that there is no demonstrable differential between their own input costs and those of the indices used in the proposed total factor productivity model.[140] The Commission should adopt a productivity factor based on the simplified price cap model as submitted by USTA.

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137 Price Cap Review Order at 9026.

138 Price Cap Review Order at 9027.

139 As an attachment to its comments, USTA has resubmitted an updated version of Dr. Christensen's presentation of that model ("USTA Christensen Update").

140 An update by Dr. Christensen of the simplified TFP study shows that the TFP differential for the price cap LECs, based on historical data using a five year moving average for the 1990-1995 time period and with appropriate adjustments, is 2.3%. ***See*** USTA Christensen Update at 3. ***See also*** the previously filed affidavit of Dr. Melvyn Fuss at ¶¶ 6, 9, 10. For the Commission's convenience and consideration in this proceeding, that affidavit is attached as Exhibit 6 to these comments.

In calculating the productivity offset, the Commission must also take into account the impact of its actions here. Historical productivity will fail to capture the drain on future productivity from access reform. In particular, productivity will be reduced by restructures that move rates from a fast-growing minutes of use basis to more static or negative growth non-traffic sensitive calculations. Dr. Christensen has quantified these impacts as yielding a change in the TFP differential of .04%, resulting in an ongoing TFP differential of 2.3%. Because of these dramatic regulatory shocks to productivity, the Commission should adjust the historical TFP calculation to reflect those changes. Because these adjustments do not take into account the future downward impact on productivity resulting from the competition unleashed by the Act, the result will still likely overstate future achievable productivity.

Because that same competition will likely alleviate the need for any price cap regulation in the coming years, the Commission need not rely on the moving average calculation. Instead, the Commission can use the adjusted TFP calculation as a fixed offset for the limited time period for which LEC services will remain under price caps.

However, if the Commission wishes to avoid even the possibility of future price cap performance reviews, it can rely on the simplified five year rolling average previously proposed by USTA. Because even a rolling average has a significant lag, the Commission should adjust the result to reflect the results of these proceedings. Such adjustments could be removed as the rolling average begins to include data reflecting post-access reform results.

Regardless, the Commission should recognize that the current "X" factor for non-sharing price cap companies overstates true productivity. The current offset of 5.3% is more than two hundred basis points above the most recently calculated TFP differential of 2.7%.[141] Therefore, no increase to the productivity offset is required -- in fact, a reduction is mandated. While returns should not be used as a benchmark for evaluating a productivity offset, the Commission relied on earnings as justification for the downward price cap adjustments in its interim price cap order. But the current economic rate of return for the industry is below 9%, and the trend is downward.[142] This is far below the current 11.25% rate of return benchmark.

Finally, the Commission should remove the sharing obligation from the price cap formula regardless of the productivity offset level. The sharing mechanism not only blunts the efficiency incentives of the price cap LECs, as the Commission has recognized, but it continues the burdensome cost allocation rules which will impede removal of services out of price caps. This is counter to the deregulatory purpose of the 1996 Telecommunications Act. As the Commission suggested,[143] eliminating the sharing mechanism, in combination with a market-based approach to access charge reform, would allow the Commission to remove the burden of regulatory cost allocation rules.

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141 ***See*** USTA Christensen Update at iii, v, Ex. 1.

142 In the price cap review proceeding, Dr. James Vander Weide filed an affidavit that demonstrated that only an economic rate of return may be properly compared to an economic cost of capital benchmark, such as the 11.25% adopted by the Commission. Attached to the USTA comments is a refiling of Dr. Vander Weide's testimony along with an updated calculation of the current and five year industry economic rates of return.

143 *See* Notice at ¶ 294.

VII. The Commission Should Use Market Forces To Resolve Other Issues. (¶¶ 216-217, 242-246, 284-288, 291-293)

A number of miscellaneous issues can be easily decided if the Commission recognizes that it should rely on market forces rather than regulatory restrictions.

A. LECs Should Gain No Advantage or Disadvantage from Universal Service Support. (¶¶ 242-246)

The Commission proposes a downward exogenous adjustment for any universal service support received by a LEC.[144] In order to ensure that such reductions accomplish only their intended purpose, the Commission must make two modifications.[145] First, such an adjustment must be limited to the portion of universal service support that covers shortfalls in interstate cost recovery. To the extent that such universal service payments are intended to cover shortfalls in intrastate payments, an exogenous adjustment would in effect be double-counting and would take away the very revenue support that the LEC has just received from the universal service fund. That would effectively eliminate the recovery intended by the payment, thereby jeopardizing universal service. Second, any such exogenous adjustment must be offset by any support payments paid by the LEC into the universal service fund, unless the LEC recovers its payments to the fund through another rate element such as a surcharge on interstate revenues. As Bell Atlantic and NYNEX have demonstrated in the universal service proceeding, they will be net

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[144] Notice, ¶ 245.

[145] Exogenous adjustments for universal service support should first be targeted to the CCL charge and then to the TIC.

payers under the proposed universal service formula.[146] It clearly would be unreasonable for them to pay twice -- first as net payers into the fund, and second through an exogenous adjustment that ignores the amounts paid out.

B. Enhanced Service Providers Should Pay Their True Costs . (¶¶ 284-288)

Although the Commission reserved the issue of information service providers and Internet usage for a separate notice of inquiry, it did tentatively conclude in this Notice that Enhanced Service Providers should not be required to pay access "as currently constituted."[147] To the extent that the Commission only intended that no changes be made prior to the order on access reform this spring, Bell Atlantic and NYNEX have no objection.

The Commission must recognize however, that Internet providers have a dramatic impact on the network already, and that impact is growing at significant rates. These usage levels can only be accommodated on the circuit switched network by continuous investment in more network capacity -- an investment that the LECs are not recovering under the current pricing structure for ESPs. Bell Atlantic has previously submitted a study that demonstrates that levels of network usage generated by ESPs result in costs that exceed revenue by two to four times, depending on the service purchased.[148]

Bell Atlantic and NYNEX have made significant investments in new technology to support the growth of the Internet, while avoiding adverse impacts on traditional voice services.

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146 ***See generally Federal-State Joint Board on Universal Service***, CC Docket No. 96-45, Reply Comments of Bell Atlantic and Reply Comments of NYNEX (both filed May 7, 1996).

147 Notice, ¶ 288.

148 Attached as Exhibit 7, is a copy of Bell Atlantic's study.

For example, Bell Atlantic's new Internet Protocol Routing Service, which is already used by several Internet service providers, collects customers' dial-in Internet calls at "ports" located at designated switching offices and transports them over a separate data network, bypassing most of the public switched network. NYNEX will soon make its comparable Internet Provider Access Service available to Internet services providers. While taking the load off the traditional voice network and its other customers, these services also make it easier for Internet service providers to manage their business by serving hundreds of customers over a single data network backbone without the expense of buying, maintaining and operating hundreds of analog lines and modems. The companies are also evaluating such technologies as Asymmetric Digital Subscriber Line (ADSL) for high-speed access to the Internet over a data network.[149]

Because of the acute need for immediate relief, the Commission should put in place a pricing mechanism now that would give Internet providers the incentive to select the appropriate network services for their traffic. If they were to begin paying for the usage sensitive costs that they impose the public switched telephone network, ESPs would have an incentive to move toward dedicated trunks and use of packet switched services, freeing capacity on the circuit switched network. The Commission should therefore mandate new interim usage sensitive charges that would allow for the recovery of some traffic sensitive costs from the Internet providers. Among the options the Commission might consider for this interim charge are (1) a specified discount from current access rates; (2) the Commission's proxy rates for unbundled

[149] Bell Atlantic and NYNEX will provide more detailed information concerning these services and other potential longer-term solutions to the problems of Internet network congestion in their response to the Commission's Notice of Inquiry on this issue.

local switching and transport, or (3) the rates for unbundled local switching and transport established by negotiated interconnection agreements or state arbitration proceedings. While ultimately all access customers should pay the same rate, an interim rate with a usage sensitive component would more accurately reflect the cost of providing circuit-switched service and would give ESPs the appropriate incentives to use network services and technologies efficiently during the time that the Commission considers the issues raised in its Notice of Inquiry.

C. Price Cap Basket Structure (¶¶ 216-217)

To complement the pricing flexibility proposed by the Commission, the price cap basket structure should also be revised. The Commission should strive for a structure that would be administratively simple and would not create new and unnecessary restraints on market pricing. Moreover, the new structure must be flexible enough to allow targeting of exogenous cost adjustments and to facilitate the removal of services from price caps as companies successfully demonstrate the presence of a competitive alternative.

The structure proposed by USTA meets these criteria. The Commission should create only one basket that would include all price cap network services and common-line costs not funded by the net receipts from Universal Service payments.[150] Under this structure, there could be four service categories that would relate to how services are actually provisioned: Tandem Switching and Transport (including the residual TIC); Common Line (including CCL and SLC); Local Switching; and Data Base Services (including 800 Database, Billing Name and Address, and Line Information Database Services). There should be no constraint at the category level for

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[150] This assumes that the Commission acts to remove from price caps the competitive services that currently are controlled by the interexchange basket.

tandem switching, transport, and local switching. An upper banding constraint of 10% may apply to database services, along with an upper limit set equal to the PCI for the common line category. In addition, each of the categories, except Database Services, should include the option of zone pricing in order to allow some pricing flexibility to meet localized pockets of more intense competition. The Commission could avoid unreasonable pricing discrimination by capping the zone differentials at 10%. Such a simplified basket structure would retain price cap restraints, but allow reasonable flexibility to respond to growing competition.

D. The Commission Should Not Require An Exogenous Adjustment For Equal Access Network Reconfiguration Costs. (¶¶ 291-293)

In the Notice, the Commission asks whether it should require the incumbent price cap LECs to make exogenous cost reductions to account for the completion of equal access network reconfiguration ("EANR") costs on December 31, 1993.[151] This issue has been raised on several occasions, and each time the Commission has rejected arguments to reduce PCIs for EANR costs.[152] In the LEC Price Cap Order, the Commission created a limited category of costs that would be treated exogenously. The LEC Price Cap Reconsideration Order made it clear that EANR costs would not be included in that category. In the LEC Price Cap Review Order, the Commission further restricted the classification of exogenous costs, limiting the types of accounting changes that would be treated exogenously and requiring waivers or declaratory

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[151] Notice, ¶¶ 292-293.

[152] Notice, ¶ 292, *citing*, ***Policy and Rules Concerning Rates for Dominant Carriers***, , Order on Reconsideration, 6 FCC Rcd 2637, 2666-67 (1991); ***1994 Annual Access Tariff Filings***, 9 FCC Rcd 3705, 3730-31 (1994); LEC Price Cap Performance Review at 9094 . ***See also Commission Requirements for Cost Support Material To Be Filed with 1994 Annual Access Tariff Filings and for Other Cost Support Material***, 9 FCC Rcd 1060, 1063 (1994).

rulings before categories of costs not listed in the Commission's price cap rules would be given exogenous treatment.[153] The LECs have many types of cost that either increase or decrease over time. The price cap system requires the LECs to bear the risk of recovering those costs, except for cost changes that are beyond their control, such as cost changes that result from changes in separations rules. Since price caps began, the Commission has treated EANR costs in the same way as other costs that the LECs bear the risk of recovering. Having decided in the past not to give the LECs exogenous treatment for any increases in EANR costs, the Commission cannot reasonably require the LECs to treat EANR costs exogenously simply because it would result in a rate decrease at this time.

153 Price Cap Performance Review at 8972, 9090.

Conclusion

The Commission should recognize that the Act has already put in place market forces that will drive down the price of access services. For the foregoing reasons, the Commission should reform its access rules to reflect the recommendations in these comments.

Respectfully submitted,

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January 29, 1997

US OFFICE PRODUCTS

Affidavit of Robert W. Crandall

Qualifications

1. I am a Senior Fellow in Economic Studies at the Brookings Institution in Washington, DC, a position that I have held since 1978.[1] Prior to that I was Acting Director, Deputy Director, and Assistant Director of the Council on Wage and Price Stability in the Executive Office of the President, and in 1974-75 I was an adviser to Commissioner Glen Robinson of the Federal Communications Commission. I was an Assistant Professor and Associate Professor of Economics at MIT between 1966 and 1974. I have written widely on telecommunications policy, the economics of broadcasting, and the economics of cable television. I am author or co-author of four books on communications policy published by the Brookings Institution since 1989: Changing the Rules: Technological Change, International Competition, and Regulation in Communications (with Kenneth Flamm), 1989; After the Breakup: U.S. Telecommunications in a more Competitive Era, 1991; Talk is Cheap: The Promise of Regulatory Reform in North American Telecommunications (with Leonard Waverman), 1996; and Cable TV: Regulation or Competition? (with Harold Furchtgott-Roth), 1996. A copy of my curriculum vitae is attached.

Introduction and Summary of Conclusions

2. I have been asked by Bell Atlantic and Nynex to provide my views on some of the alternatives proffered by the Commission for restructuring interstate access charges. The Commission's Notice of Proposed Rulemaking in this matter represents a much-needed

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[1] The views expressed herein are solely my own and should not be taken to represent the views of the Brookings Institution, its other staff members, or its Trustees.